

GENERAL FUND REVENUE UPDATE FISCAL 2004

A Report Prepared for the
Legislative Finance Committee

By
Terry W. Johnson
Principal Fiscal Analyst
And Staff

June 18, 2004

Legislative Fiscal Division



www.leg.state.mt.us/css/fiscal/

INTRODUCTION

The purpose of this report is to provide the committee with information on significant general fund revenue trends that are occurring in fiscal 2004. The 2005 biennium outlook table that traditionally is included in the report has not been updated. This is because estimated payments for both corporation and individual income taxes that were due June 15th are not expected to be completely processed until late June.

At the committee meeting in March, our office expressed concerns over some of the revenue trends that were developing based on data through the end of February 2004. This report is based on information received through the end of May 2004.

The report is organized in three relevant sections. The first section discusses the fiscal 2004 general fund revenue outlook including a discussion of selected general fund revenue sources. The second section addresses significant economic trends that illustrate why selected revenue collections have changed from the House Joint Resolution 2 (HJR 2) estimates. The third section provides a summarization based on information received so far this fiscal year.

2004 GENERAL FUND REVENUE OUTLOOK

FISCAL 2004 REVENUE TRENDS

Based on information recorded through the end of May 2004 on the Statewide Accounting, Budgeting, and Human Resource System (SABHRS), total general fund receipts for fiscal 2004 were \$1,067.7 million as shown in Table 1. This compares to \$962.6 million collected for the same period of fiscal 2003. Total general fund collections are \$105.0 million above last year's amount, which represents a 10.9 percent increase.

Revenue Source	Actual Fiscal 2003	Estimated Fiscal 2004	Through 5/31/03	Through 6/1/04	Difference	% Change	HJR2 Estimated % Change
GF0100 Drivers License Fee	2,119,499	2,850,000	1,892,158.52	2,578,134.77	685,976.25	36.2536%	34.4657%
GF0200 Insurance Tax	50,809,600	56,038,000	35,593,377.12	41,847,985.31	6,254,608.19	17.5724%	10.2902%
GF0300 Investment Licenses	5,141,561	4,618,000	4,876,321.70	4,498,591.27	(377,730.43)	-7.7462%	-10.1829%
GF0400 Vehicle License Fee	75,185,331	79,774,000	60,279,433.78	67,787,538.57	7,508,104.79	12.4555%	6.1031%
GF0500 Vehicle Registration Fee	28,352,232	31,762,000	22,564,571.23	24,848,819.51	2,284,248.28	10.1232%	12.0265%
GF0600 Nursing Facilities Fee	5,859,871	5,704,000	4,411,374.07	4,399,813.01	(11,561.06)	-0.2621%	-2.6600%
GF0700 Beer Tax	2,771,455	3,058,000	2,277,540.94	2,354,647.55	77,106.61	3.3855%	10.3392%
GF0800 Cigarette Tax	12,576,306	34,993,000	7,565,763.94	31,955,744.00	24,389,980.06	322.3730%	178.2455%
GF0900 Coal Severance Tax	9,721,540	8,384,000	7,493,224.48	6,715,732.60	(777,491.88)	-10.3759%	-13.7585%
GF1000 Corporation Tax	44,137,518	64,762,000	35,944,302.26	48,508,960.44	12,564,658.18	34.9559%	46.7278%
GF1100 Electrical Energy Tax	4,130,019	4,408,000	2,736,156.34	3,452,796.77	716,640.43	26.1915%	6.7307%
GF1150 Wholesale Energy Trans Tax	3,532,056	3,432,000	2,650,227.49	2,408,114.22	(242,113.27)	-9.1356%	-2.8328%
GF1200 Railroad Car Tax	1,484,264	1,688,000	1,348,785.50	1,526,754.02	177,968.52	13.1947%	13.7264%
GF1300 Individual Income Tax	535,830,664	558,059,000	464,140,087.82	511,909,065.31	47,768,977.49	10.2919%	4.1484%
GF1400 Inheritance Tax	13,305,983	7,516,000	11,094,666.68	10,760,948.91	(333,717.77)	-3.0079%	-43.5141%
GF1500 Metal Mines Tax	4,586,335	2,967,000	3,057,556.48	1,737,645.95	(1,319,910.53)	-43.1688%	-35.3078%
GF1700 Oil Severance Tax	29,086,038	26,932,000	8,763,674.61	19,664,898.90	10,901,224.29	124.3910%	-7.4057%
GF1800 Public Contractor's Tax	3,081,553	3,354,000	2,879,361.03	1,532,644.25	(1,346,716.78)	-46.7714%	8.8412%
GF1850 Rental Car Sales Tax	0	2,180,000	-	1,864,863.08	1,864,863.08		
GF1900 1.5 VoTech Levy	883,986	893,000	502,115.94	581,706.67	79,590.73	15.8511%	1.0197%
GF2000 40 Statewide Levy	64,767,167	65,095,000	39,191,866.36	40,194,236.90	1,002,370.54	2.5576%	0.5062%
GF2100 55 Statewide Levy	106,028,709	108,323,000	62,687,037.91	62,702,090.86	15,052.95	0.0240%	2.1638%
GF2150 Lodging Facilities Sales Tax	571,237	8,807,000	-	6,390,681.70	6,390,681.70		
GF2200 Telephone Tax	33,498	-	33,498.02	22,346.07	(11,151.95)	-33.2914%	-100.0000%
GF2250 Retail Telecom Excise Tax	20,804,524	21,190,000	15,062,629.96	15,029,408.11	(33,221.85)	-0.2206%	1.8528%
GF2300 Tobacco Tax	2,304,532	3,174,000	1,748,529.73	2,990,891.67	1,242,361.94	71.0518%	37.7286%
GF2400 Video Gaming Tax	45,794,025	45,012,000	34,062,515.29	37,458,219.94	3,395,704.65	9.9690%	-1.7077%
GF2500 Wine Tax	1,339,799	1,283,000	1,120,465.85	1,180,145.05	59,679.20	5.3263%	-4.2394%
GF2600 Institution Reimbursements	13,042,526	16,757,000	9,909,198.97	11,555,870.56	1,646,671.59	16.6176%	28.4797%
GF2650 Highway Patrol Fines	4,109,703	4,697,000	3,393,256.86	3,469,490.25	76,233.39	2.2466%	14.2905%
GF2700 TCA Interest Earnings	6,366,439	14,060,000	5,452,811.43	5,342,033.71	(110,777.72)	-2.0316%	120.8456%
GF2900 Liquor Excise Tax	10,042,488	10,239,000	8,291,404.17	8,812,257.14	520,852.97	6.2818%	1.9568%
GF3000 Liquor Profits	6,000,000	5,400,000	-	-	-		-10.0000%
GF3100 Coal Trust Interest Earnings	36,297,863	37,187,000	27,228,428.43	26,074,765.08	(1,153,663.35)	-4.2370%	2.4496%
GF3300 Lottery Profits	7,453,281	5,595,000	3,735,586.00	4,609,667.00	874,081.00	23.3988%	-24.9324%
GF3450 Tobacco Settlement	18,699,611	3,105,000	18,486,670.00	2,933,928.09	(15,552,741.91)	-84.1295%	-83.3954%
GF3500 U.S. Mineral Leasing	25,989,828	23,469,000	19,747,602.62	21,809,492.27	2,061,889.65	10.4412%	-9.6993%
GF3600 Other Revenue	<u>44,140,179</u>	<u>34,074,000</u>	<u>32,387,708.49</u>	<u>26,144,970.47</u>	<u>(6,242,738.02)</u>	-19.2750%	-22.8050%
Grand Total	\$1,246,381,220	\$1,310,839,000	\$962,609,910.02	\$1,067,655,899.98	\$105,045,989.96	10.9126%	5.1716%

This trend by itself indicates that general fund revenue growth for fiscal 2004 may be above expectations since total revenues were expected to increase by 5.2 percent from actual fiscal 2003 collections. If the growth rate drops below 5.2 percent, the revenue estimate contained in HJR 2 will not be achieved. Estimated collections for fiscal 2004 are from HJR 2 adjusted for impacts of legislation enacted during the 58th Legislature.

While the growth rate of 10.9 percent is above the adjusted HJR 2 estimated rate of 5.2 percent, there are unusual events occurring between fiscal years that make this comparison misleading. For example, cigarette tax, lodging facilities sales tax, and rental car sales tax are not comparable to last year because of legislation enacted by the 58th Legislature.

DISCUSSION OF SELECTED REVENUE SOURCES FOR FISCAL 2004

As explained in the previous section of the report, a comparison of total revenues from the previous fiscal year to the current fiscal year can be misleading. Not only can statutory modifications change revenue trends, but changes in general economic conditions can also skew aggregate growth trends.

Table 2 Comparison of Selected Revenue Sources to HJR2 Estimates			
Revenue Source	Actual Fiscal 2003	HJR2 Estimated Fiscal 2004	HJR2 Estimated Chg From 2003
Cigarette Tax	12,576,306	34,993,000	22,416,694
Corporation Tax	44,137,518	64,762,000	20,624,482
Individual Income Tax	535,830,664	558,059,000	22,228,336
Inheritance Tax	13,305,983	7,516,000	(5,789,983)
Oil & Natural Gas Production Tax	29,086,038	26,932,000	(2,154,038)
Video Gaming Tax	45,794,025	45,012,000	(782,025)
TCA Interest Earnings	6,366,439	14,060,000	7,693,561
U.S. Mineral Leasing	25,989,828	23,469,000	(2,520,828)
All Other Sources	533,294,419	536,036,000	2,741,581
Totals	\$1,246,381,220	\$1,310,839,000	\$64,457,780

As shown in Table 2, the 58th Legislature assumed general fund revenues would increase by \$64.5 million from fiscal 2003. Included in this amount was \$22.4 million of cigarette tax revenue anticipated from increasing the tax rate to \$0.70 per pack. If this additional cigarette tax revenue is excluded from the total, all the remaining general fund revenues were expected to increase by \$42.1 million or 3.4 percent. The majority of this increase was expected from individual and corporation taxes and treasury cash investment earnings.

The following section of the report addresses five selected revenue sources whose estimated fiscal 2004 collections are anticipated to be significantly different than estimated by the 58th Legislature. Table 3 shows these sources of revenue plus a combination of all other revenue sources and the potential change between estimated collections and HJR 2 estimates for fiscal 2004. The changes portrayed in Table 3 are based on economic and accounting information received through May 2004.

Table 3 Potential Change From HJR2 Revenue Estimate	
Revenue Source	Millions Fiscal 2004
Individual Income Tax	25.541
Inheritance Tax	4.600
Oil & Natural Gas Production Tax	10.768
Video Gaming Tax	5.138
TCA Interest Earnings	(7.143)
All Other Sources	1.332
Totals	\$40.236

Individual Income Tax - \$25.5 million

Income tax receipts for fiscal 2004 are expected to be \$25.5 million above estimates in HJR 2 adjusted for legislation. Gross collections (actual collections plus refunds added back) through May of 2004 were 10.3 percent above gross collections through May 2003, whereas HJR 2 anticipated a growth of 4.1 percent. This increased growth is mostly caused by larger than anticipated impacts of the federal Jobs and Growth Tax Relief Reconciliation Act enacted in May 2003 (see below) and larger growth in Montana wages and salaries. It was estimated in HJR 2 that growth between calendar years 2002 and 2003 would be 4.2 percent, but according to the Bureau of Economic Analysis, actual growth was 5.0 percent. Table 4 shows specific details of individual income tax collections through May of this year compared to the same period of fiscal 2003.

Table 4 Individual Income Tax Comparison					
Revenue Code & Description	Through 5/31/2003	Through 06/01/04	Difference	Percent Change	
	Fiscal 2003	Fiscal 2004			
510101 Withholding Tax	389,126,528.20	413,892,001.12	24,765,472.92	6.36%	
510102 Estimated Tax	122,292,520.02	123,456,742.11	1,164,222.09	0.95%	
510103 Current Year I/T	81,007,811.56	97,062,500.73	16,054,689.17	19.82%	
510105 Income Tax - Audit Collections	20,108,135.00	22,678,181.00	2,570,046.00	12.78%	
510106 Income Tax Refunds	(148,394,906.96)	(145,180,359.65)	3,214,547.31	-2.17%	
Totals	\$464,140,087.82	\$511,909,065.31	\$47,768,977.49	10.29%	
Percent of Actual/Estimated	86.62%	91.73%			

Impact of Federal Tax Relief on State Income Tax Revenues

In May of 2003, the federal Jobs and Growth Tax Relief Reconciliation Act of 2003 was signed into law. This act accelerated the phased-in tax relief that had been passed in 2002, the Jobs Creation and Workers Assistance Act, hereafter referred to as the 2002 law. The Jobs and Growth Tax Relief Reconciliation Act accelerated tax rate reductions on ordinary income; accelerated the provisions dealing with marriage penalty relief, the expansion of the 10 percent bracket, the child tax credit, reduced tax rates on capital gains and dividends; and increased business deductions.

State income tax receipts as a result of the Act were expected to increase by approximately \$23 million during the 2005 biennium. The provisions of the act are as follows:

- Reduce capital gains tax rates for long term gains to 15 percent and tax rates on dividends to 15 percent – this will increase state income tax collections as state taxpayers claim less federal taxes deductible.
- Accelerate federal tax rate reductions – instead of phasing-in the reduction in federal tax rates over many years, as the 2002 federal law required, the rates that would have been in effect in tax year 2006 will apply to tax year 2003. This will increase state income tax collections as state taxpayers claim less federal taxes deductible.
- Expansion of 10 percent bracket – under the 2002 federal tax changes, the expansion of the 10 percent bracket was to have taken place in tax year 2008. The Act implements this expansion beginning in tax year 2003. However, this provision ends beginning in tax year 2005 and the prior phase-in will resume. This will increase state income tax collections.
- Marriage penalty relief – under the 2002 federal tax changes, marriage penalty relief was to be phased-in with full phase-in taking place in tax year 2009. Under the Act, the 2009 relief is available in tax years 2003 and 2004. In tax year 2005, the relief reverts to the 2002 law phase-in amounts. This will increase state income tax collections.
- Expansion of the child tax credit – under the 2002 federal tax changes, the child tax credit was to be phased-in until it was \$1,000 in tax year 2010. The Act raises the child tax credit to \$1,000 in tax years 2003 and 2004, after which it reverts to the 2002 law phase-in amounts. This will increase state income tax collections.
- Alternative minimum tax exemptions – the Act temporarily raises the exemption amount in tax years 2003 and 2004, after which the exemption amounts revert to their previous level. This will increase state income tax collections.
- Increase deduction amounts for code 179 expensing – this raises the amount that can be expensed in one year to \$100,000 from the current amount \$25,000, for tax years 2003 through 2005. Because the state income tax system follows federal tax rules regarding expensing, this provision will decrease state tax revenues.
- Increase bonus depreciation to 50 percent in first year of life of equipment for equipment purchased between May 1, 2003 and January 1, 2005 - the 2002 law allowed a 30 percent bonus depreciation in the first year after purchase. This provision will decrease state tax revenues.

Inheritance Tax - \$4.6 million

Inheritance tax collections continue to be strong following the unpredictably high collections of fiscal 2003. While HJR 2 anticipated \$5.8 million less in collections as the federal estate tax is eliminated, revenues in fiscal 2004 are just slightly less than revenues collected in the same period of fiscal 2003. Analysis of inheritance tax collections show that in fiscal 2004, normal collections have fallen off substantially, yet five large estates with tax liabilities in excess of \$0.8 million have been settled. Two of those estates had tax liabilities of over \$1.0 million. As a result, inheritance tax collections are expected to exceed the HJR 2 estimates by \$4.6 million in fiscal 2004.

Oil & Gas Production Tax - \$10.8 million

As of May, revenue from oil and natural gas production taxes was above fiscal 2003 collections, primarily due to much higher prices for both commodities. Also, special low tax rates for incentive production were increased temporarily in the 2nd quarter of fiscal 2003 because the price of West Texas Intermediate (WTI) oil was above \$30 per barrel. Current law requires tax rates on stripper and alternative oil wells be increased during each quarter that WTI is above \$30 per barrel. The current forecasts of oil and natural gas production tax revenues for fiscal 2004 exceed those in HJR 2 by \$10.8 million.

The HJR 2 oil price for fiscal 2004 was between \$21.00 and \$22.00 per barrel. The monthly average West Texas crude oil price has experienced steady increases since September 2003, reaching a record high of \$40.28 per barrel in May.

Video Gambling Tax - \$5.1 million

Video gambling revenue is derived from two sources: license fees and video gambling taxes. The fifteen percent tax on gross income less payouts produces the majority of the collections from this source. Because the revenue growth reported in March is continuing, collections through the end of fiscal 2004 are expected to exceed HJR 2 estimates by \$5.1 million. The HJR 2 growth assumptions were premised on a peak in machine play with growth abated from historical levels. Current collection trends do not support this assumption.

TCA Interest Earnings - (\$7.1 million)

Treasury cash account interest revenue is based on the amount of cash available to invest and the prevailing short-term interest rates. Both factors have declined. Cash balances in the account have decreased, necessitating the need to borrow more money than anticipated for cash flow purposes. In addition, the federal discount interest rate has plummeted from 6.0 percent in December 2001 to 0.75 percent in December 2002 and has remained at this level. Data from the Board of Investments show the yield on the treasury cash account for fiscal 2003 was 2.3 percent. The yield to date for fiscal 2004 is about 2.2 percent. This compares to the HJR 2 short-term interest rate assumption of 4.7 percent.

All Other Sources - \$1.3 million

The combined changes of the remaining 30 other revenue sources are a small portion of total revenue changes. This indicates that, of the remaining revenue sources, the positive changes nearly equal the negative changes.

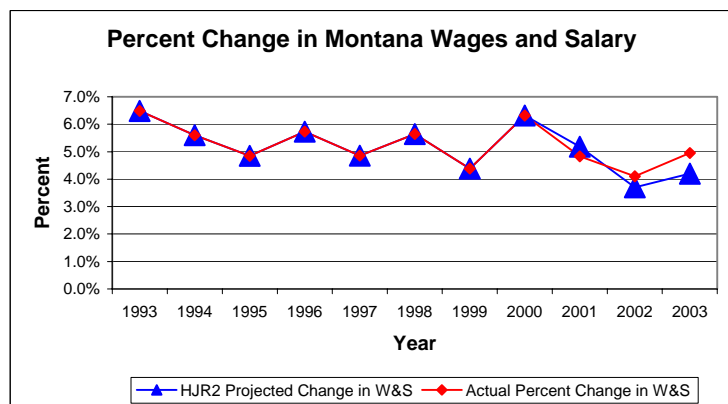
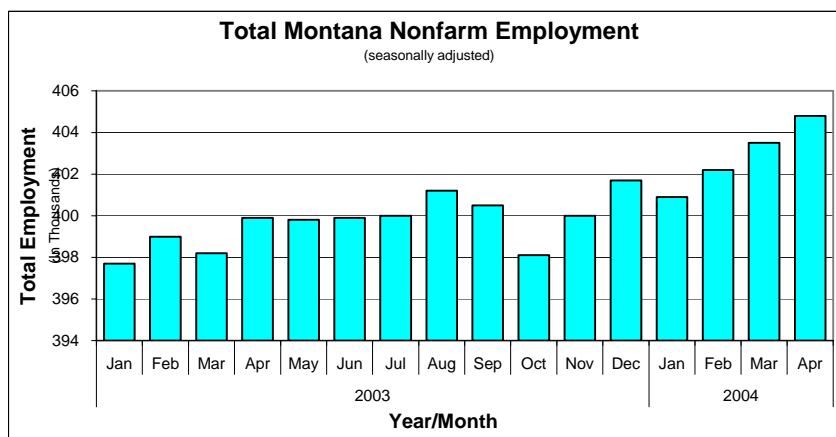
SIGNIFICANT ECONOMIC TRENDS

An improved economic climate in both Montana and the country has had a generally positive impact on the state's revenue collections. Montana revenues are sensitive to many factors such as corporate profitability, prevailing interest rates, capital gains/losses, energy prices, and federal tax changes. The following is a brief summary of current relevant articles and reports that illustrate the impact of these economic factors on the state revenues.

Montana Employment and Wages

Statistics from the Montana Department of Labor and Industry (DLI) depict continued improvement in the labor market, with average weekly earnings in Montana's private production sector up 2.4 percent over the year in April, 0.1 percent above inflation for the same period. Furthermore, nonfarm payroll employment was up 4,900 jobs from April 2003, an increase of 1.2 percent over the year in April. Increases were observed in almost all industrial sectors.

Nationally, while employers are adding jobs at a faster pace than has been evident in the past four years, investors may become concerned if the trend slows the gain in corporate earnings. In April, 346,000 jobs were added to the national economy, and 947,000 jobs have been created in the past three months. Additionally, wages increased 0.3 percent in the month of May (*Strong Job Growth Could Trim Profits*, CNNMoney, June 4, 2004).

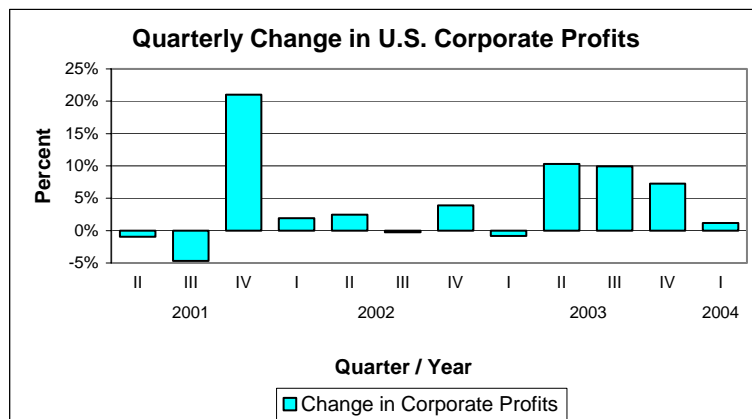


Montana wages and salaries have exceeded the growth estimates in the HJR 2 projections. In the estimate, wages were expected to grow 3.7 percent between calendar years 2001 and 2002 and 4.2 percent from 2002 to 2003. According to the Bureau of Economic Analysis, actual growth for those periods was 4.1 percent and 5.0 percent respectively.

Corporate Profits

The Bureau of Economic Analysis estimates that US corporate profits increased 1.2 percent (at a quarterly rate) in the first quarter after increasing 7.2 percent in the fourth quarter of 2003. Profits of domestic corporations increased about 3.5 percent in each quarter of 2003, and total profits and profits of domestic corporations were each more than 30 percent higher than a year earlier (*Corporate Profits Increase*. Bureau of Economic Analysis, May 27, 2004).

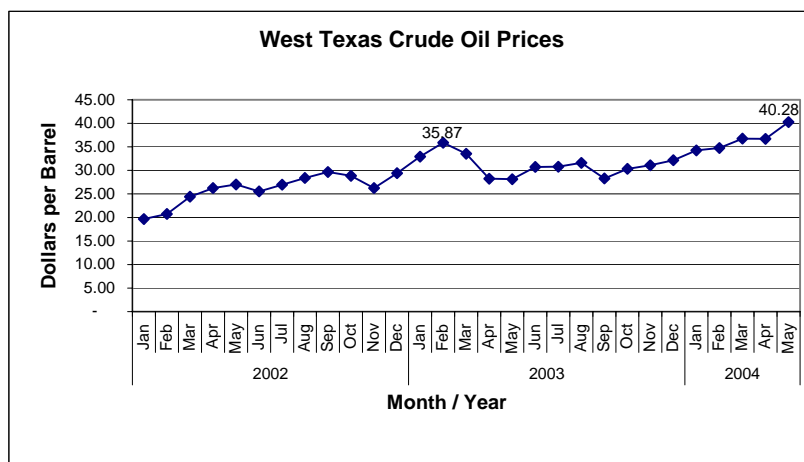
Montana's corporation tax collections are now showing a stronger correlation with national improvements in corporate profits. Both the collections of estimated payments and current year corporation tax collections are better than expectations three months ago. Growth in corporation profits has been positive since the second quarter of 2003, suggesting a long-range improvement in corporation income tax collections.



Oil Prices

The price of West Texas Crude has exceeded expectations since the beginning of 2003. The monthly average West Texas crude oil price has experienced a steady increases since September 2003, reaching a record high of \$40.28 per barrel in May of 2004.

July delivery crude oil prices fell 3.7 percent to \$37.28 a barrel. NYMEX crude has fallen from an all-time high of \$42.43 a barrel on June 2. Increased stockpiles of crude oil and gasoline will help force prices lower, and the pressure is expected to hold the price of crude lower than earlier expected. However, strained world supply and tensions in Iraq, Saudi Arabia, and Africa have lead to fears of supply disruption, which could in turn cause prices to increase (*Oil Skids to 6-Week Low*. CNNMoney, June 8, 2004).



Prices of crude oil are significantly higher than projected in HJR 2. The estimated per barrel price in 2003 was \$22.30 and \$21.80 in 2004. The annual average West Texas price for crude oil in 2003 was \$31.14 and to date in 2004 is \$36.54 per barrel. A continuation of exceptionally high oil prices will have a positive effect on future oil and natural gas revenues.

Interest Rates

The Free Open Market Committee (FOMC) is expected to raise interest rates when it meets June 29-30. With the core consumer price index, excluding food and energy prices, rising at a 3 percent annual pace, an interest rate increase is expected to keep raising inflation in check. Recent gains in the national employment picture will also play a role in increasing the rates, as increased employment levels indicate that the economy is again heating up. The level of the federal deficit brings even further pressure to bear on interest rates. In a speech on June 10th, former Treasury Secretary Rubin stated that, "The (federal) deficits of the magnitude we're now talking about would have a substantial adverse impact on interest rates, productivity, and our economy" (*Poole Suggests Faster Rate Hikes*. CNNMoney, June 11, 2004).

Interest rates have a significant impact on all of Montana's trusts and interest bearing accounts. While lower rates help to lower the cost of debt service on the state's loans and bond issues, it also reduces the revenues earned on many of the state's financial instruments.

SUMMARY

Based on data through the end of May 2004, total general fund revenues have the potential to exceed HJR 2 revenue estimates by \$40.2 million. While the outlook for some revenue categories, such as investment earnings, has not improved since March, the overall general fund revenue picture has improved substantially. The tax sources with significant changes from the HJR 2 estimates are individual income, oil and gas, video gambling, and inheritance taxes. It should be noted that this report is based on data through the end of May. During June and the fiscal year end adjustment period (July 1 to July 23), significant revenues are recorded on the accounting system. Both cash and accrual transactions recorded could change the potential excess revenue previously outlined in this report. A full report on the financial status of the general fund account for fiscal 2004 will be released in October.

The obvious question this report generates is, “What does this information indicate for fiscal 2005 and beyond?” These trends portray a more optimistic outlook for the future, but a thorough analysis of the “permanent” versus “one-time-only” nature of these collections is imperative. Without this information, erroneous conclusions could be easily be construed. This analysis will be done during the summer and fall in preparation for the revenue estimate process of the Revenue and Transportation Committee.